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**INDONESIA  
MUNICIPAL FINANCE AND  
SHELTER PROGRAM:  
THIRD YEAR ASSESSMENT**

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**Tim Koordinasi Pembangunan Perkotaan,  
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## *Section 1*

### **INTRODUCTION AND SUMMARY**

#### **PURPOSE**

This report assesses the progress that has been made during the third year (August 1990-July 1991) of Indonesia's Municipal Finance and Shelter Program. Under their joint agreement for this Program: (a) the U.S. Agency for International Development (USAID) is providing a \$100 million Housing Guaranty Loan (HGL) for capital investment and \$5 million in Development Assistance (DA) grants for technical assistance and training; and (b) the Government of Indonesia (GOI) is implementing a Policy Action Plan whose goal is to "improve the shelter conditions of the urban poor by developing the means by which municipal governments can finance shelter-related urban services and infrastructure at a pace sufficient to overcome present deficits and match the pace of urban population growth" (see USAID/Indonesia, 1988).

The first \$25 million tranche of HGL funds was authorized soon after the Program was initiated in 1988, and two more tranches in the same amount have been authorized since then, based on assessments of performance during the Program's first and second years (Johnson, 1989; and Kingsley, 1990). In assessing third-year performance, this report's primary purpose is to serve as a basis for USAID decisions concerning the Program's fourth and final \$25 million authorization. However, it also considers what the Program's experience may imply for potential future AID assistance in the urban sector in Indonesia.

#### **THE POLICY ACTION PLAN**

The Policy Action Plan, against which progress is assessed, is a broad plan for the coordination and decentralization of urban development in Indonesia. It was initially

established in 1987 (TKPP, 1987a), and updated several times since then, (most recently in May 1990--TKPP, 1990a) to serve as the base for the Government's management of its own activities and coordination of all external donor support, in this sector. The program is administered by an interministerial coordinating group (Tim Koordinasi Pembangunan Perkotaan--TKPP) chaired by a Deputy of the National Planning Agency (BAPPENAS). The Plan's targets for accomplishment are organized under six major policies related to:

1. Strengthening and clarifying local government responsibility for urban infrastructure.
2. Implementing a coordinated and decentralized process for programming urban infrastructure investment.
3. Enhancing local government resource mobilization, financial management, and involvement of the private sector in infrastructure and service delivery.
4. Establishing effective mechanisms to support municipal borrowing and improving the system for allocating intergovernmental grants.
5. Strengthening the institutional capacity of local governments.
6. Improving intergovernmental coordination and consultation in urban development.

## OVERALL CONCLUSIONS

Considering the findings summarized in the paragraphs to follow (and detailed in the body of this report), the overall conclusions of this assessment are:

**Program Accomplishments.** The GOI has made substantial progress under all components of the Plan over the past year, giving it yet more stature and momentum than it had a year ago. Highlights include: making continued progress in decentralized investment programming and local revenue generation, laying the groundwork for much expanded private sector participation, adopting precedents that should improve the structure of municipal borrowing and central grant allocations, beginning civil-service reforms that promise to enhance local government capacity, making a serious commitment to upgrading the status of some local governments, strengthening systems for overall program monitoring and control, and clarifying responsibility for program coordination at the central level.

**Priorities for Improvement.** Progress has been slower than promised in: (1) providing a viable nationwide system of loan finance for local governments, including the full institutionalization of a Regional Development Account (RDA); (2) bringing a larger share of grants for regional and local development under the discretion of local officials; (3) expediting improvements in local institutional capacity and enhancing the role of local officials in the investment programming process; and (4) updating (and making more concrete) the Plan's targets for future achievement. Also, special emphasis should be given to systems to assure that local governments honor their debt service obligations.

The evidence seems clear, however, that the GOI remains committed to these objectives and continues to pursue them actively.

**The Importance of AID's Role.** It is noteworthy that, while USAID was not involved when the Policy Action Plan was established, its support has become much more central to the program, particularly over the past year. First, AID technical assistance has expanded in key policy areas (including support for central policy analysis and coordination) that were not being addressed by other donors. Second, HGL funds have become vital to the investment program, as the level of capital support from other donors has declined. Analysis of the use of initial HGL tranches indicates that true additionality has been achieved--a condition that was not required under the terms of the loan agreement.

**The Potential for Future AID Assistance.** Census data have shown that urban growth in Indonesia in the 1980s was much more rapid than had been anticipated. This has heightened the GOI's concerns about urban development. In addition to the challenges already being explicitly addressed under the current Policy Action Plan, there is a new sense of urgency concerning urban economic development (job generation and poverty alleviation), urban land management, and urban environmental degradation. Attempting to mount totally new initiatives in these areas outside the framework of the current Plan, however, could be dangerous. It should become clear that *the most promising way to address these new issues and achieve the objectives already established, is by more forceful implementation --with appropriate adaptation-- of the basic themes of the existing Policy Action Plan.*

Continued support from external donors for some years will be essential if the delivery system promised by this Plan is to become fully institutionalized and self-sustaining. Particularly considering the key role USAID support has played of late, the potential contribution of an effective deployment of additional HGL and related technical assistance and training resources is substantial at this point. To best take advantage of this opportunity, *a new HGL would be based on the GOI's perseverance with all elements of the Plan, but give special emphasis to those which are the focus of USAID technical assistance initiatives: developing a disciplined system of municipal finance, expanding private sector participation in urban services, and creating more effective land and environmental quality management.*

Further evidence of the GOI's commitment in the short term should be important in USAID's consideration of both the disbursement of the fourth tranche under the current loan and the prospects for a new HGL. This should include taking more definite steps toward an effective system of credit finance for local governments, and preparing a full Policy Action Plan update, with a definite schedule for achievement.

**PERFORMANCE: LOCAL RESPONSIBILITY AND THE INVESTMENT PROGRAM**  
(Policies 1 and 2)

The core of this component is the Integrated Urban Infrastructure Development Program (IUIDP), a phased decentralization process in which local government staff (with technical assistance from the center) develop mutually consistent: (1) spatial development plans (at least in an outline form); (2) multi-year multi-sectoral investment programs (PJMs); (3) plans showing how the PJMs will be financed (RIAPS, which cover all sources of funds, including enhanced local revenue generation as well as external loans and grants); and (4) plans for building local institutional capacity (LIDAPs).

**1990/91 Accomplishments.** IUIDP implementation continued at a rapid pace over the year. PJMs are in preparation or completed for urban areas accounting for 81 percent of the nation's urban population (up from 75 percent a year ago). From the start of the program through January 1991, 116 local governments had initiated PJMs (58 of which had been finalized) and 65 had initiated RIAPS and LIDAPS (47 of which had been finalized). The portion of the urban population living in areas with finally approved PJMs jumped from 9 percent in 1989/90 to 17 percent in 1990/91. The Ministry of Home Affairs (MHA) now requires that local governments that have them use their PJMs and RIAPS as the basis for their submissions in the traditional annual budget negotiations with the central government (RAKORBANG).

The total investment associated with the program (including that programmed by central agencies as well as directly through the PJM process) grew from Rp. 324 billion in 1986/87 to Rp. 659 billion in 1987/88 and Rp. 793 billion in 1988/89, largely due to a major increase in resources made available through the Urban Sector Loan (USL) from the World Bank. With the depletion of funding from that source, the phasing in of HGL resources has played an important role in allowing the GOI to sustain the level at Rp. 728 billion in 1989/90 and an estimate of over Rp. 800 billion in 1990/91.

The share of these totals planned and implemented directly by local governments (as opposed to central agencies) increased from 39 percent in 1987/88 to 44 percent in 1989/90. While further increasing that share remains a dominant goal, there is evidence of a benefit largely overlooked in that central agencies are also increasingly programming their own activity ("DIP financed") consistent with locally developed PJMs.

**Priorities for Improvement.** The GOI has recognized the need for a process that will move local officials more into the dominant role in ongoing PJM/RIAP preparation and implementation, and improve their effectiveness as urban managers, but that process has been slow to emerge. Plans have been made for technical assistance to begin to address these needs, with support from both the UNCHS IUIDP Implementation Support Project and USAID. These plans should be coordinated and expedited. Also, while their involvement is being reduced, it is clear that central agencies will play a role in urban investment programming for some time to come. Targets should be established

with regard to changes that will help them overcome present sectoral biases and further enhance the consistency of their own DIP planning (composition and timing) with locally developed PJMs.

**HGL Additionality.** Although the terms of the HGL agreement give the GOI considerable latitude as to how it may apply the proceeds from the loan, it has chosen to channel those funds directly into the urban investment program defined above. Its 12/90 certification (subsequently field tested by AID staff) documents eligible expenditures (by city and project, from 4/89 through 12/91) of \$50.26 million in HGL funds devoted directly to the provision of urban infrastructure services to below-median income households.

#### **PERFORMANCE: LOCAL RESOURCE MOBILIZATION AND PRIVATE SECTOR PARTICIPATION (Policy 3)**

**1990/91 Accomplishments.** (1) The GOI program to improve the performance of the property tax (PPB) continued according to plan: PPB administrative reforms are now being implemented in Indonesia's 12 largest cities (accounting for half of the national urban population), and PPB receipts increased from Rp. 590 billion in 1989/90 to an estimated Rp. 620 billion in 1990/91. (2) The implementation of the MAPATDA system was extended to all local (Tk.II) governments this year and solidified in those where it was initiated over the past two years--comments from many local officials indicate that MAPATDA has been the primary contributor to the recent nationwide increases in local revenues (for example, subnational government non-PBB taxes went up from Rp. 365 billion to Rp. 814 billion from 1985/86 to 1989/90). (3) The effort to expand private sector participation in urban services gained substantial momentum with more active GOI task force work to examine means of eliminating barriers to private involvement and several new private sector projects actually being initiated. This momentum was advanced by two USAID assisted initiatives: a major study and seminar on practical steps to expanding private participation in water supply (assisted under the Municipal Finance Project-MFP), and the preparation of the new \$20 million PURSE (Private Participation in Utilities and Urban Services) project, which will provide support for changes in policies and the legal/regulatory environment, technical assistance, and demonstrations in this area over the next four years (within the GOI, PURSE will report to TKPP, which should much improve its integration in the overall decentralized urban development program).

**Priorities for Improvement.** National analysis has not been conducted to show what progress has been made over the past year on one objective under this policy: improving cost recovery and financial management in local public enterprises. Earlier in the program, the MHA promulgated guidelines on tariffs and accounting procedures for local water enterprises (PDAMs). Studies of selected PDAMs had shown that the initial results were mixed, but comprehensive information on more recent experience is

not available. It appears that steps have not been taken to extend these approaches to other local enterprises (BUMDs) as had been planned for this year. A comprehensive review of PDAM and BUMD financial performance, and the subsequent development of a clearer improvement program, should be targeted for the program's next stage.

**PERFORMANCE: CREDIT FINANCE AND INTERGOVERNMENTAL GRANTS**  
(Policy 4)

While steps to enhance local revenue under Policy 3 are critical, the Plan has always looked more to two efforts under Policy 4 for truly substantial increases in the capacity of local governments to finance their infrastructure requirements. The first is a significant expansion of local borrowing. Since the mid-1980s, some central government and donor funds have been passed on to local governments in the form of loans, albeit at highly subsidized interest rates. This has given them some experience with credit financing, but the amounts involved have been small. To more adequately address the need, the Plan has called for the creation of a new lending facility--the Regional Development Account (RDA)--which was to charge high enough rates to cover its true costs so that it would be able to maintain its capital base and, ultimately, attract additional funding from private capital markets. The second initiative was to reform current laws so as to increase local discretion over the use of central government grant funds for urban development.

Through mid-1990, progress in both areas had been disappointing. Substantial planning for the implementation of RDA had been completed, but the GOI had not finally agreed on the basic principles for its operation. A number of proposals for reform of the grants system had been advanced, but there was no definitive timetable for the adoption of a new law.

**1990/91 Accomplishments.** One year later, promising drafts for a decree establishing the RDA for nationwide operations and for laws revising central-local fiscal relations and local taxing authority have reached high levels in the decision process, but final approvals have not been attained on either front. Nonetheless, precedents were set this year that further both objectives.

In conjunction with a major World Bank loan supporting investment through the IUIDP process in East Java and Bali, the GOI has stipulated that: (1) a significant share of the loan proceeds will be on-lent to local governments through Domestic Lending Arrangements that, for the first time, contain a formula mandating that interest rates gradually increase toward the market rate (the mechanism will use administrative rules and procedures designed for the RDA); and (2) a significant share of the funds that normally would have been spent by the central agencies in the past will be channeled directly as grants to local governments through a special SPABP mechanism under the authority of Inpres.

Another important precedent in this project is an effective loan-grant linking mechanism. Large and small (rich and poor) urban areas whose PJMs are financed at the same time will have to pay the same interest rate on the loan portion of the funds they receive. But, based on objective assessments of their debt payment capacities, poorer cities will receive a much larger share of total program financing in the form of a grant, whereas richer cities will receive more as loans. Thus, even though the interest rate may be the same, poorer cities will have to pay interest on a much smaller share of their total financing. The total cost to them will be substantially lower than for the more developed areas. Without a mechanism like this, it would be politically difficult to charge progressively increasing interest rates to all local governments, even though doing so will be essential to protecting the integrity of the fund and, thereby, accelerating resource mobilization over the longer term.

The GOI has indicated its intention to follow similar arrangements in other urban lending in the future and, with respect to the grant provisions, planning is underway for the creation of a new general Inpres Perkotaan which, like the SPABP mechanism, would give local governments wider discretion in the allocation of grant funds for urban development. It is also significant that the GOI has budgeted substantial absolute increases in total Inpres allocations of late: from Rp. 1.1 trillion in 1988/89 to Rp. 2.3 trillion for 1990/91 and Rp. 3.3 trillion for 1991/92. While several of the Inpres channels have too many strings attached, these grants are at least locally administered.

**Priorities for Improvement.** Again over the coming year, final implementation of a properly structured credit finance mechanism and further steps to expand local discretion in the use of central grant funds should be among the highest priorities of the overall program. This means, in effect, finally agreeing to implementing something like the precedents set in the East Java/Bali project nationwide.

Also, the program should more explicitly recognize the RDA as an interim mechanism to expand local credit finance in the short run, while the longer term goal should be to pave the way for local government access to private capital markets. The fact that the province of East Java is now considering a bond issue to finance development projects is the first strong indication of subnational government interest in this approach. It seems doubtful that the conditions needed to support a true municipal bond market will develop in the next two to three years, but, exploratory studies and preliminary planning to guide the transition along these lines should be a part of the 1991/92 agenda.

Finally, it is important to note that the future prospects for credit finance for local governments depend critically on demonstrating they are credit worthy. Emphasis should be given this year to developing a forceful program to assure those governments do not fall behind in their debt service payments on existing loans.

**PERFORMANCE: LOCAL INSTITUTIONAL CAPACITY**

(Policy 5)

**1990/91 Accomplishments.** Two concerns raised in this area in the HGL Second Year Assessment are now being addressed. First, the GOI is implementing a major reform of its civil service system which, among other things, intends to remove existing biases against career advancement for government staff working at the province and local (as opposed to the central) level, while making government service a more attractive career path in general. Second, the MHA has begun to upgrade the status of local governments. One Kota Administratif (Bitung) has been reclassified as a Kotamadya, and seven more such reclassifications are planned.

**Priorities for Improvement.** While a well-regarded study of the institutional and manpower development needs of urban local governments was completed under the program in 1988, action has not been taken to implement its recommendations. Much of this was to have occurred under a World Bank-sponsored Local Government Institutional and Manpower Development Project, however, it appears that the GOI and the World Bank have so far been unable to agree on the structure of this project. The development of some forceful and coordinated plan of action in this area, specifically related to urban governments, should be among the program's highest priorities over the coming year.

**PERFORMANCE: PROGRAM MANAGEMENT AND MONITORING**

(Policy 6)

**1990/91 Accomplishments.** (1) Clarifying management responsibility by vesting the chairmanship of TKPP (composed of representatives of relevant ministries at the Director General level) with Deputy V (responsible for spatial development) in BAPPENAS; (2) Strengthening the new IUIDP Management Group (IMG), operating in support of TKPP--made up of representatives at the Director level, responsible for week-to-week coordination of the investment program; (3) The TKPP Chairman's submission (2/91) of an overall examination of the program, reviewing performance and highlighting issues to be addressed; (4) The staffing of technical assistance teams under the UNCHS-administered IUIDP Implementation Support Project and AID's Municipal Finance Project (MFP); (5) Initial development of statistical systems to monitor overall program performance; (6) An effort (with MFP assistance) to rationalize and coordinate the many information systems proposals that have emerged in support of the overall program; and (7) Initial planning toward updating the national urban strategy.

**Priorities for Improvement.** (1) The TKPP Chairman's 2/91 review was an essential foundation for the next update of the Policy Action Plan, but that update (translating general statements into concrete targets with schedule dates) is urgently needed to restore program momentum. (2) New data systems to support overall

monitoring represent a good start but additional indicators are needed and the revised system should be institutionalized (i.e., used as the basis for regular review in TKPP meetings). (3) While they have been working in a mutually supportive way, the work technical assistance teams provided under the IUIDP Implementation Support Project and AID's MFP should be more closely coordinated to heighten their impact. (4) The proposal to update the national urban strategy should be translated into a concrete and practical work plan and, because of its fundamental importance to operations as well as the strategy, the highest priority should be given to location-specific analysis of 1980-90 urban population growth in a form comparable to that done in the NUDS project.

### **FUTURE PROGRAM DEVELOPMENT AND THE POTENTIAL ROLE FOR AID SUPPORT**

***The Importance of Program Continuity.*** Observers of, and participants in, Indonesia's decentralized urban development program, as delineated in the Policy Action Plan, have at times been discouraged about its rate of progress. Although some of this was due to unrealistic expectations, there is no doubt the program could have moved more rapidly in some areas.

Nonetheless, the program's achievements continue to be impressive in world terms. Its basic themes, first articulated in 1985, have remained constant for over six years, and while forward movement has not always been as rapid as hoped for, there has not been any actual backsliding on any of them. There can be little doubt that the program, particularly IUIDP implementation, has fundamentally changed the way that Indonesia approaches the development of its cities and towns.

In addition, there appears to be a general consensus in the Indonesian policy community that the right course of action in the 1990s is to continue to reinforce the same themes: locally directed and disciplined, multi-sectoral investment programming; expanded local authority and responsibility for resource mobilization and allocation; an expanded private sector role; and substantial improvements in local government capacity and incentives for its efficient performance in response to local needs. Surely, there is much more work to do on all of them and all must be coordinated (it is clear that failure in any one would severely constrain success of the others). Also, it should be self-evident that the program is likely to proceed more effectively under the continued pressure of an interministerially supported and coordinated Policy Action Plan at the central level--one that is regularly monitored and adapted in response to changing trends and the emergence of new opportunities. The greatest threats to continued progress would be to disband TKPP and the Plan or to establish alternative mechanisms that weaken them.

***Weaving New Themes into the Fabric of the Existing Plan.*** With new evidence on the acceleration of urbanization, there is greater recognition that the future quality of life in Indonesia will be predominantly determined by what happens in its cities and

towns. It is natural that there should be a greater concern with new issues that may not appear to be addressed by the existing program, most importantly, urban land management, urban environmental quality management, and urban economic development (job generation and poverty alleviation). And it is natural that some new programs should be developed to address these issues.

However, recent international research supports the conclusion that **local governments' success in guiding and controlling urban development in these and other ways depends, more than anything else, on the effectiveness of their capital budgeting processes (in Indonesia, the PJM/RIAP/LIDAP process)**. Why is this the case? (1) The placement of major roads and other trunk infrastructure is the most powerful tool governments have for guiding the physical shape of urban expansion and thus the structure of urban land use. Although their positive impact can be improved, regulations are a weak and often counterproductive alternative. (2) The most serious urban environmental problems are related to land use--urban expansion into coastal lands, watersheds, flood prone terrain, and other environmentally sensitive areas--and the lack of infrastructure--clean water, decent sanitation, and drainage). (3) Cities can best facilitate the growth of higher productivity employment opportunities (the only effective means of alleviating poverty in the long term) by creating local conditions that enhance the efficiency and competitiveness of local *private* enterprise (the widespread failure of public economic enterprise as an alternative is now well documented). A number of studies have shown that the provision of efficient public infrastructure systems and the elimination of arbitrary constraints in the land market are among the most effective ways local governments can reduce the costs of doing business for private firms, thereby, making their local economies more competitive.

***The Potential for Future AID Assistance.*** When the Policy Action Plan was first established, the World Bank relied on it as the basis for its lending agreements with the GOI. USAID came along later and did the same. The World Bank, however, is no longer referencing its loans to progress on the overall program (although, along with the Asian Development Bank, it continues to support its themes in its lending for program elements in various regions). At this point, USAID's HGL funds are the only external resources explicitly keyed to integrated achievement under this program nationwide.

Analysis by several donors has concluded that, even though Indonesia's domestic resource mobilization efforts are succeeding, a reasonable growth path will require external capital assistance for many years to come, and this is particularly true in the urban sector. Accordingly, it would seem reasonable for USAID to provide access to additional HGL resources with basically the same understanding that has been applicable over the past few years; i.e., *that disbursements of each tranche be based on the GOI's continued progress in implementing its decentralized urban development Policy Action Plan as a whole.*

USAID technical assistance to the program will continue under the already contracted Municipal Finance Project through mid-1994, contributing in a number of ways to the development of a much improved system of local government finance. The new PURSE project (running through 1996) to expand private sector participation in urban services will also clearly contribute to the objectives of this program--particularly since its steering committee is also the TKPF. Two other issues for the future, raised in the TKPF Chairman's 2/91 submission, could be combined to form a third focus for USAID technical assistance support: urban land and environmental quality management. These issues are clearly becoming more urgent. They can best be addressed through the framework of the existing Plan, and because USAID has already supported initial studies in these areas it is in a good position to pursue them further.

Further evidence of the GOI's commitment in the short term should be important in USAID's consideration of both the disbursement of the fourth tranche under the current loan and the prospects for a new HGL. This should include taking steps toward an effective system of credit finance for local governments (including the establishment of a properly structured RDA), and preparing a full Plan update (with a definite schedule for achievement).

## **STRUCTURE OF THIS REPORT**

The remaining sections of this report present more detailed findings concerning GOI progress under each element of the program: local responsibility and the investment program (Section 2); local resource mobilization and private sector participation (Section 3); credit finance and intergovernmental grants (Section 4); and local institutional capacity and program coordination (Section 5). In these sections, materials on "program rationale" and "program development through 1990" are provided to facilitate understanding by readers not familiar with the program (they are reproduced from the text of the HGL Second Year Assessment with only minor modifications). Section 6 provides more discussion on themes for future program development and the potential for AID support. Annex A gives background information on the structure of Indonesia's public finance system and Annex B is a list of references.

## *Section 2*

### **LOCAL RESPONSIBILITY AND THE INVESTMENT PROGRAM**

#### **IUIDP PROGRAM RATIONALE**

Through the mid-1980s, virtually all urban infrastructure in Indonesia was planned by central government agencies in Jakarta (primarily in Ministry of Public Works--MPW) and implemented by their field offices in the provinces. The programs of one central office (e.g., water supply) were seldom coordinated with those of another (e.g., drainage), either spatially or temporally, and local officials had little chance to influence them.

As cities and towns began to grow much more rapidly, there was greater recognition that this approach could not be sustained logistically, let alone respond sensitively to the varying needs of different urban areas. Many central officials came to believe that the only satisfactory long-term solution would be for local governments to assume full responsibility for providing (and largely financing) their own urban services. This approach was endorsed in the National Urban Development Strategy (NUDS, 1985). However, it was also clear that few of Indonesia's local governments then had the capacity to assume this role effectively.

The IUIDP response to this dilemma is a phased approach to decentralization in which the central government supports local capacity building at the same time that it works with existing local staff in planning and implementing investment programs (see TKPP, 1987b; Hendropranoto Suselo, 1984; and 1988). In its idealized form, the process entails the following steps: (1) meetings are held with provincial governments to review NUDS analyses and prioritize cities for attention; (2) project teams in the selected cities (local staff with technical assistance provided from the center) review and update local master plans or develop a new "structure plan" where none is available; (3) teams then

use those plans as a guide in developing a proposed local multi-year investment program (PJM) integrated across several sectors; (4) the teams are also required to prepare a complete financing plan (RIAP) that covers the enhancement of local revenues and borrowing as well as support from the central budget and/or external donors; (5) plans (LIDAP) are also prepared for building the capacity of local government to assume ever increasing responsibility for infrastructure development, operation, and maintenance; and (6) individual city programs so defined are then reviewed at the province and central levels and decisions are made about the allocation of central loan and grant funds.

To date, IUIDP has been limited to functions that had traditionally been the responsibility of MPW's Directorates General Cipta Karya (water supply, sanitation, drainage, kampung improvement) and Bina Marga (urban roads). It was reasoned that trying to cover more functions at the start might add complexity and threaten program viability--other functions could be added later after the IUIDP had proved itself.

## **PROGRAM DEVELOPMENT THROUGH 1990**

IUIDP has been implemented nationwide under guidelines issued in 1987 (TKPP, 1987b). Progress is detailed in Directorate Bina Program, 1990a, and cogently summarized in Tjahjati, 1990. Through July 1989, initial PJMs had been prepared or were in preparation for key urban areas in almost all provinces, covering in total approximately 75 percent of Indonesia's 1980 urban population.

In addition, further efforts were made to clarify responsibility for the development and operation of various categories of infrastructure. A new policy statement (PP 14 1987) set forth parameters assigning functions more clearly at the local level. Infrastructure was inventoried in ten cities, and central and local officials reached joint agreements on more specific allocations in those cities (i.e., maps of all roads were marked to demarcate which level of government and which specific agency would be responsible for the development upkeep of each road link). Lessons from these exercises were then used as a basis for similar classification as a part of PJM preparation elsewhere (Directorate Bina Program, 1989; and TKPP, 1989a).

In 1989/90 new emphasis was placed on improving the operations and maintenance (O&M) of infrastructure through the Performance Oriented Operations and Maintenance Management System (POMMS, see P.T. Perencana Aneka Sarana and DeLeuw Cather, Inc., 1990), which was designed and tested in eight cities. Another notable achievement was Directorate Bina Marga's effort in shifting virtually all urban road planning into the IUIDP framework.

Partly because initial targets were so ambitious, there have been many problems in IUIDP implementation (see UNDP, 1989; and Tjahjati, 1990). Many local governments have not yet internalized the process or developed the capacity to operate it effectively.

It also became clear that the initial guidelines were too cumbersome and did not permit enough flexibility to adapt to varying local needs and priorities.

Nonetheless, IUIDP has generally been regarded as a major accomplishment. Its basic characteristics (integrated planning across sectors based on city-specific conditions, the linkage to financial discipline through the RIAPs and to capacity building through the LIDAPs) in and of themselves have been seen as a dramatic improvement over the approach of the past. Also, efforts continue to be made to rectify problems as they are identified; e.g., by revising IUIDP guidelines (see, for example, TKPP, 1989b).

## **1990/91 PERFORMANCE**

### **Program Implementation**

IUIDP implementation continued at a rapid pace over the year. PJMs are underway or completed for urban areas accounting for 81 percent of the nation's urban population (up from 75 percent a year ago). From the start of the program through January 1991, 116 local governments had initiated PJMs (58 of which had been finalized) and 65 had initiated RIAPS and LIDAPS (47 of which had been finalized). Many PJMs moved into the final stages of financing and some into full implementation. The portion of the urban population living in areas with finally approved PJMs jumped from 9 percent in 1989/90 to 17 percent in 1990/91.

Two other signs of progress are important. First, the MHA now regularly requires that local governments that have them use their PJMs and RIAPs, developed through IUIDP, as the basis for their submissions in the traditional annual budget negotiations with the central government (RAKORBANG). Interviews during this mission suggest that local government (Tingkat II) officials are increasingly conforming to this requirement.

Second, often overlooked is the impact PJM/RIAP preparation has had on the central agencies that have traditionally planned and implemented urban infrastructure programs (principally Cipta Karya and Bina Marga). MPW instructions, in fact, now require these agencies to conform their own investment plans to PJMs where they exist. More important, perhaps, than instructions on paper, is the political power the existence of a locally developed PJM creates. In the early 1980s, when local governments had no coherent capital improvement programs of their own, they had little rationale for complaining about a central agency's implementing a project in their territories without sufficient prior negotiation. Now, when a PJM exists, there is a sound basis for appealing against any central agency initiative that does not conform to it. Interviews during this mission indicated that such appeals are now generally upheld and that, accordingly, the central agencies are progressively less likely to initiate projects inconsistent with PJMs.

**Table 2.1**  
**THE URBAN INVESTMENT PROGRAM, 1987-1988, 1990-1991**  
 (Current Rp. in billions)

	TOTAL	1987/88	1988/89	1989/90	1990/91
<b>USE OF FUNDS</b>					
Water Supply	1,025.2	250.6	230.7	198.9	315.1
Flood Prevention	519.9	103.7	119.5	105.3	191.4
Env. San. & Drainage	340.5	72.0	108.4	66.9	93.2
Kampung Improvement	213.5	38.8	59.4	52.0	63.4
Roads	976.5	146.7	204.3	255.8	369.7
Planning	198.7	47.3	41.2	48.8	61.4
Total	3,274.3	659.1	793.5	727.7	1,094.1
<b>SOURCE OF FUNDS</b>					
National					
Cipta Karya	919.3	215.5	235.8	202.0	266.0
Other	916.2	183.7	215.0	206.0	311.5
Subtotal	1,835.5	399.2	450.7	408.0	577.5
Local					
Domest. Loans	191.8	27.2	64.8	8.5	91.4
INPRES	461.6	70.5	72.0	106.8	212.4
SDO	28.2	4.2	19.7	2.0	2.3
APBD I & II	461.2	75.3	138.8	131.1	116.1
PDAM	296.1	82.8	47.6	71.3	94.4
Subtotal	1,438.8	259.9	342.8	319.6	516.6
Total	3,274.3	659.1	793.5	727.7	1,094.1

SOURCE: TKPP. (1990/91 data = budget, all others = actual)

### The Investment Program

Tables 2.1 and 2.2 present data on the core of the urban investment program from 1987/88 through 1990/91 (including investment programmed by central agencies as well as directly through the PJM process).<sup>1</sup> They show a substantial increase in total

<sup>1</sup>The data on these tables include O&M expenditures as well as capital investments for the basic needs subsectors covered under IUIDP. Similar data (isolating expenditures directly in urban areas) are not available for other subsectors such as energy, telecommunications, and port and market development.

**Table 2.2**  
**THE URBAN INVESTMENT PROGRAM, 1987-1988, 1990-1991**  
 (Percent of Total)

	TOTAL	1987/88	1988/89	1989/90	1990/91
<b>USE OF FUNDS</b>					
Water Supply	31.3	38.0	32.9	27.3	28.8
Flood Prevention	15.9	15.7	15.1	14.5	17.5
Env. San. & Drainage	10.4	10.9	13.7	9.2	8.5
Kampung Improvement	6.5	5.9	7.5	7.1	5.8
Roads	29.8	22.3	25.8	35.2	33.8
Planning	6.1	7.2	5.2	6.7	5.6
Total	100.0	100.0	100.0	100.0	100.0
<b>SOURCE OF FUNDS</b>					
<b>National</b>					
Cipta Karya	28.1	32.7	29.7	27.8	24.3
Other	28.0	27.9	27.1	28.3	28.5
Subtotal	56.1	60.6	56.8	56.1	52.8
<b>Local</b>					
Domest. Loans	5.9	4.1	8.2	1.2	8.4
INPRES	14.1	10.7	9.1	14.7	19.4
SDO	0.9	0.8	2.5	0.3	0.2
APBD I & II	14.1	11.4	17.5	18.0	10.6
PDAM	9.0	12.6	6.0	9.8	8.6
Subtotal	43.9	39.4	43.2	43.9	47.2
Total	100.0	100.0	100.0	100.0	100.0

SOURCE: TKPP. (1990/91 data = budget, all others = actual)

investment associated with the program--from Rp.324 billion in 1986/87 to Rp. 659 billion in 1987/88 and Rp. 793 billion in 1988/89. The increase in these years is largely explained by the major increase in resources made available through the Urban Sector Loan (USL) from the World Bank. With the depletion of funding from that source, however, GOI contributions expanded significantly. Clearly, the phasing in of the HGL resources also played an important role in allowing the program to sustain the level at Rp. 728 billion in 1989/90.

Data on 1990/91 in the tables are budgeted figures. Information on actual realization for some local resources in that year are not yet available. However, data provided by TKPP indicates that realization of expenditures funded from national sources in 1990/91 did increase to Rp.479 billion--up 18 percent from the Rp. 408 billion of the previous year. Those categories for which 1990/91 realization data are available also show increases. It seems likely that the 1990/91 budget total shown on Table 2.1 will not be achieved but, nonetheless, that expenditures will go up notably from those of the previous year--almost surely to more than Rp. 800 billion.

**Use of Funds.** For the four years shown, the largest share of funds was spent on water supply systems (almost one-third) and local road extensions and improvements (30 percent). Sizeable shares also went to flood protection (15 percent) and environmental sanitation and drainage (10 percent), with smaller allocations given for the Kampung Improvement Program (KIP) and urban planning. The most notable compositional change over the period was an increase in the total share going to road improvements (from 22 percent in 1987/88 to 34 percent in 1990/91) and a corresponding decrease in the proportion going to water supply. Other allocations remained relatively constant proportionally.

**Source of Funds.** An important shift over the period was the increase in the share of these totals invested directly by local governments--from 39 percent in 1987/88 to 44 percent in 1989/90. The largest sources of these local funds were INPRES (14 percent) and the regular Tk. I and II APBD budgets (also 14 percent). The most notable change here was the increase in the INPRES share (from 11 percent in 1987/88 to 15 percent in 1989/90). Loans accounted for a fairly small percentage overall (6 percent) but that proportion is higher than for most other categories of capital investment by local government, and it has been increasing. Within the central government component, the share controlled by DG Cipta Karya declined (from 33 percent to 24 percent) as those of other central agencies (notably DG Bina Marga) increased.

### **The HGL Contribution**

Although doing so is not required under the terms of the lending agreement, the GOI has channeled HGL resources directly into projects delivered through this program (HGL-supported projects are clearly identified and advertised as such). A report on these expenditures (Directorate Bina Program, 1990b) shows a total of \$50.26 million (just in excess of the amount of the first two tranches) certified as HG-eligible over the period from 4/89 through 12/91 (i.e., they are exclusive of support from other donors and are delivered to below-median income households).

Of the total, \$38.77 million are for projects being administered by DG Cipta Karya: 52.5 percent of this amount is for water supply projects, another 21.1 percent is for KIP projects, while shares of 7 percent or less each are allocated for projects in human waste and sanitation, drainage and flood control, solid waste disposal, access road

improvement, and urban planning. The remaining \$11.49 million is being channeled to the sector via loans through a Ministry of Finance Regional Development Account (RDA) window.

### **Priorities for Improvement**

One of IUIDP's highest priorities is to move local officials more into the commanding role in ongoing PJM/RIAP preparation and implementation. In the first rounds of IUIDP, many local officials did work closely with the consultant teams and controlled key decisions but, as noted earlier, this was not true everywhere (Tjahati, 1990). Even where local leadership was fairly strong, there remains a need for further strengthening of skills.

With direct MHA participation, the IMG has made plans to improve local participation in the next stages of the process. Technical assistance support has been scheduled from both the UNCHS IUIDP Implementation Support Project and USAID. In these efforts, consultants are to work directly with officials in selected cities, review past IUIDP activities, and develop capacity-building programs as appropriate. The USAID-assisted project will look more deeply into overall local management capacity and offer recommendations for improvements. After these projects are reasonably far along, results will be widely disseminated and guidelines and manuals will be developed (and revised) as appropriate. Mobilization of these initiatives is now behind schedule. The work should be expedited, and careful monitoring by IMG will be required to assure that they are well coordinated and lead to an internally consistent set of guidelines for future improvements. The results of these efforts should, of course, be built into further local government training programs (see discussion in Section 5).

A second initiative in this area should be considered as an addition to the current Plan. Because local capacity development will take time, central agencies (Cipta Karya and Bina Marga in particular) will have to continue playing a role in urban investment programming for some time to come. As noted earlier, they have already substantially modified their procedures in DIP programming to be consistent with IUIDP. Cipta Karya's Directorate Bina Program, in fact, still plays the central day-to-day role in managing IUIDP technical activity in the field.

More progress along these lines, however, could be beneficial. Additional steps (including organizational changes) may be appropriate to reduce sectoral biases of the past and reinforce the integrated multi-sectoral approach in individual urban areas. A new study conducted within MPW is suggested to explore ways of further modifying central agency DIP planning and implementation to become more fully compatible with, and integrated within, the IUIDP process.

### Section 3

#### **LOCAL RESOURCE MOBILIZATION AND PRIVATE SECTOR PARTICIPATION**

Discussion in this section is organized around the four main objectives under Policy 3 of the Policy Action Plan: (1) improving the revenue performance of the property tax (PBB); (2) improving the cost recovery by local enterprises; (3) improving the revenue from local government taxes and service charges; and (4) increasing the involvement of the private sector in local infrastructure and service provision. As background for readers not familiar with Indonesia's public finance system, Annex A reviews its overall structure and 1980s trends in the composition of revenues and expenditures.

#### **STRENGTHENING THE PROPERTY TAX (PBB)**

##### **Program Development Through 1990**

The most important initiative here was probably the change in the basis of taxation from a rental (actual or imputed) value approach to a system based on the market value of the property (land plus improvements). Beyond this, virtually every aspect of the administrative system is being changed. Almost all aspects were tested in the Tangerang Pilot Project, which was largely implemented by mid-1989 (see HIID, 1989 and 1990.)

1. *Property Information.* A new, streamlined Property Information Declaration Sheet (Surat Pemberitahuan Obyek Pajak, SPOP), piloted in Tangerang, is being implemented nationwide as a part of the US\$ 6 million Property Information (Pendataan) project. The project is targeting to collect one million new or updated SPOPs from throughout Indonesia.

2. *Property Valuation.* A more efficient valuation process has been designed, calling for individual valuations of high value properties (replacement cost method supplemented by checks on sales of comparable properties) and an index-based mass assessment system for other properties. A computer system to implement and document this work was developed and satisfactorily tested in Tangerang. By July 1990, valuation of the first 10,000 high value parcels (8,000 in Jakarta, 1,000 in Surabaya, and 1,000 in Medan) had been completed, and work was underway on the next 50,000. A successful experiment was also completed in Tangerang in which data from the national electricity agency (PLN) were used to update the tax rolls (and led to the discovery of a number of high-value properties not previously on the rolls).

3. *Collection and Enforcement.* In the past, property taxes were generally paid to local officials (Lurah). Payments could be made at a number of locations and payment schedules varied. The new approach, tested in Tangerang, involves banks as the primary collection agents. Letters inform taxpayers that they must make their payments at only one location (Payment Point) in their Kecamatan or Kelurahan. A common due date is established for all taxpayers. Copies of all payment notices are sent to the bank by the tax office. After the due date, the banks return the receipts collected plus the notices for any cases where payment was not made. This provides a clear record of delinquency. Dunning letters are then sent to delinquent taxpayers. Given the increased credibility of the new system, returns after the first letter were considerably higher than originally expected. The system was fully operational in Tangerang in July 1989, and in 1989/90 receipts there jumped to Rp. 8.2 billion, almost doubling the 4.2 million collected the previous year.

### **1990/91 Performance**

Measures aimed at strengthening the administration and the yield from the PBB have been among the most successful in the overall program to date. PBB administrative reforms, largely confined to Jakarta and Surabaya through 1990, are now being implemented in Indonesia's 12 largest cities--accounting for half of the national urban population. PBB revenues nationally grew from Rp. 168 billion in 1985/86 to Rp. 590 billion in 1989/90, and a further increase to Rp. 620 billion is estimated for 1990/91. (World Bank, 1991c)

## **COST RECOVERY**

### **Program Development Through 1990**

In the early 1980s, local water supply was provided by BPAMS--in effect, subunits of the MPW. Since then, most have been reestablished as independent enterprises (PDAMS) and efforts have been made under the program to enhance their fiscal integrity. Studies were completed to design realistic new tariff structures. These were endorsed by

a Ministry of Home Affairs decree (Pemendagri 690-536 of June 1988) and guidelines were promulgated on improved accounting systems. Substantial increases in cost recovery were attained in some cities that have implemented the new tariffs, although many have yet to do so.

Efforts to improve cost recovery by PDAMs continued over 1989/90 but with mixed results. An analysis of performance in 30 PDAMs was completed and, in these cases, problems were identified and action plans for corrective actions were prepared. The studies indicated that some PDAMs had substantially increased revenues, but many others had still not implemented new tariff structures (often being held back because they have not received formal approval from local officials as is now required). Also, capacity problems had been evidenced in implementing recommended management systems. Studies were undertaken to promote further strengthening (for example, in applying the financial management guidelines developed by the USAID-sponsored Water and Sanitation for Health (WASH) Project--see McCullough and Walker, 1990).

### **1990/91 Performance**

It is unclear what progress has been made over the past year in this area. A clear program for improvement has been designed for a number of PDAMs under the World Bank-assisted East Java-Bali project (World Bank, 1991a), but aside from that, information on more recent experience is not available. There is no indication that steps have been taken to extend the new approaches to other local enterprises (Badan Usaha Milik Daerah, BUMD) as had been planned for this year. A comprehensive review of PDAM and BUMD financial performance, and the subsequent design of a clear improvement program, should be targeted for the program's next stage.

## **OTHER LOCAL TAXES AND SERVICE CHARGES**

### **Program Development Through 1990**

Indonesia's provincial and local governments have traditionally earned revenue from a variety of additional taxes and service charges, although their yield has been small--24 percent of total routine revenue for provinces and only 6 percent for lower level governments (Quigley, 1990). The program in this area has been aimed at rationalizing these sources (including eliminating some where administrative costs are not warranted by the revenues received), and strengthening the administration and improving the yield of those that remain. By mid-1990, a systematic approach for achieving these ends had been designed (Manual Administrasi Pendapatan Daerah, MAPATDA), manuals had been prepared, and implementation had been initiated in 200 local governments (P.T. Sumber Sarana Sempurna, 1988 and 1989). Results were impressive. Estimates included, for example, a tenfold increase in the radio tax in Surabaya, and a sixfold increase of same

in Pasuruan and a doubling of business license revenue and an 850 percent increase in receipts for solid waste collection in Kabupaten Jember.

### **1990/91 Performance**

By early 1991 the MAPATDA system had been installed in all Tk. II governments in Indonesia. The new Monitoring Indicators report of the Municipal Finance Project (1991b) shows that income from these additional local taxes and service has increased significantly over the past few years. For example, from 1985/86 to 1989/90, subnational government non-PBB taxes went up from Rp. 365 billion to Rp. 814 billion. Interviews held during this mission and comments of local officials at the USAID-supported Municipal Finance seminar last December (Municipal Finance Project, 1990) give MAPATDA considerable credit for this change. They indicate that most local governments have found the system understandable, are using it, and have found it has focused their efforts on more efficient collection of these resources.

## **PRIVATE SECTOR PARTICIPATION**

### **Program Development Through 1990**

Considering limitations in local government capacity, involving private firms in various aspects of urban service provision (ranging from direct investment to playing roles in operations and maintenance) is an important opportunity for Indonesia. A new objective was added to the Policy Action Plan in 1989 to recognize this potential. Workshops to stimulate interest in the approach had been held as early as 1988 (see, for example, Hendropranoto Suselo, et al., 1988) and the government was active in promoting it in 1989/90. The Chairman of BAPPENAS, for example, devoted a major address to this approach, stating "... we are looking increasingly to the private sector to finance and operate physical infrastructure and to upgrade skills" (Affif, 1990). He noted public-private partnerships that have recently been initiated in interurban (toll) roads, industrial estates, electric power, and telecommunications facilities. He also extolled the important role being played by the (private) informal sector in many aspects of urban services (e.g., water vendors, informal transport operators, and pemulung in solid waste collection).

Initial studies were completed to identify constraints and opportunities for an expanded private sector role. The study by P.T. Deserco and M. Macdonald and Partners (1989) study outlined how several approaches could be applied in Indonesia (including the Build, Operate, Transfer method, or BOT) and reviewed potential for private sector water supply schemes in 16 cities.

More important, new private ventures in urban services were actually initiated (or were in the negotiation stage) in several localities. These included: (1) the Umbulan bulk

water supply project (4 cubic meters per second) for Surabaya; (2) a BOT water supply scheme for Lhok Semaue offered by the government to a private consortium; (3) a major drainage project for northern Jakarta; and (4) a bulk water supply program for Semarang. In Surabaya, private firms have already been used extensively by the PDAM for bill collection, an approach that has been promoted in other areas.

### **1990/91 Performance**

Momentum in this area over the past year has been furthered by the GOI's general emphasis in expanding the role of the private sector in national development. It has been recognized that, after Indonesia's fundamental structural reforms in the early 1980s to reduce its dependence on oil, the successful diversification economy has been largely due to the response of private firms (see World Bank, 1991c).

Specific to this sector, two initiatives (both USAID supported) are noteworthy in establishing a base for much greater private involvement in urban services. The first is the WASH/MFP (1991) project on expanding private participation in water supply. This project reviewed successful private projects in a number of sub-sectors in Indonesia and other countries and then developed a proposed strategy and administrative guidelines for planning and implementing projects involving private firms in water supply. The results were reviewed by a broad array of government officials at a seminar in Bali in May (Municipal Finance Project, 1991). The second is the effort, just now being completed, to design the four-year, \$20 million Private Participation in Utilities and Urban Services (PURSE) project, which aims for major changes in the regulatory environment (to eliminate barriers to, and provide positive incentives for, private participation) and will provide technical assistance and training (both to public officials and private managers and entrepreneurs), and demonstration projects. Within the GOI, PURSE will report to TKPP, which should assure its integration in the overall decentralized urban development program.

While these preparatory efforts were underway, various GOI agencies have established working groups to further this objective and a number of new projects have been initiated (documented in WASH, 1991) including, for example: 14 toll road projects (806 km.) now in the design stage; the new Nusa Dua bulk water supply project in Bali; and a variety of new efforts in electric power and telecommunications. Also, there appears to be continued support under IUIDP for the expansion of community and NGO involvement in planning local improvement and O&M projects.

#### Section 4

### **CREDIT FINANCE AND INTERGOVERNMENTAL GRANTS**

#### **PROGRAM RATIONALE**

The methods of resource mobilization discussed in Section 3 are important but alone incapable of generating the increases in local resources needed to meet the requirements of rapid urban growth. Two objectives related to more substantial resource mobilization are stated under Policy 4 of the Policy Action Plan.

The first calls for a significant expansion of local borrowing to finance urban infrastructure. Through the mid-1980s local borrowing experience in Indonesia was negligible. Yet in developed countries, reliance on credit for local capital development is dominant. Loans have an important leveraging effect, permitting localities to make much larger investments in any given year than that year's budget could support, because they can defer payments over a multi-year period. Since major capital investments yield benefits over many years, financing them out of today's revenues in fact puts an unreasonable burden on today's taxpayers.

The second objective is to increase local discretion over the use of central government grant funds for urban development. As noted in Annex A, only a small portion of all central grants have been transferred in the form of block grants that could be programmed by local officials based on their own assessments of priorities. It was reasoned that local governments have much stronger incentives than the center to apply funds efficiently in response to real local priorities, thus higher cost-benefit ratios would be achieved if they could control a larger share of grant investment. Also, experience in other countries suggests that residents are more likely to be willing to pay more for services if they have more choice about what services to buy and how they should be delivered.

## **CREDIT FINANCE**

### **Program Development Through 1990**

In the late 1980s, efforts were made to pass more central government and donor funds on to local governments in the form of loans, albeit at highly subsidized interest rates. Bastin (1990) estimates that total subnational government borrowing from central government sources (volume of contracted loan sums, not disbursements) since 1974 has amounted to about Rp. 1.8 trillion. He notes that these funds have been borrowed for a variety of functions, including water supply, markets (Inpres Pasar), urban roads, KIP, and bus terminals, as well as liquidity credits for government owned regional development banks (Bank Pembangunan Daerah, BPD).

**Local Government Borrowing Experience to Date and Demand for Credit Finance.** Over Repelita IV (1984/85-1988/89), local borrowing represented less than 5 percent of total regional development expenditures (including the DIP regional development component) but roughly 15 to 20 percent of urban sector expenditures. In 1986/87, total disbursements on provincial and local government loans reached Rp. 61.8 billion. The volume of lending to subnational governments and enterprises has more than doubled since then, mostly because it was decided to pass on much of the surge in foreign assistance loans to them through subsidiary lending agreements. Even though the magnitudes have still not been high, this should be regarded as a step forward because it gave local governments some experience with credit financing.

In 1990, HIID conducted a survey of subnational government borrowing. Bastin (1990) reviewed the preliminary findings. Most important, results indicate that there is evidence of substantial regional government loan demand. Many local governments already do borrow for a number of functions, in many cases on commercial terms. This is true even though the grant system competes directly with the lending option (no functional differentiation) and since grants are available to all regardless of ability to pay, grants are naturally preferred. Nonetheless, grants are not always available and local officials are under pressure to expedite infrastructure development. Commercial credit is used in part because the process of borrowing from central government is lengthy and cumbersome (borrowers may have to wait for more than a year before a commitment is made). The survey found that 40 percent of the local governments, 75 percent of the PDAMs, and 65 percent of the BUMDs responding consider loans as a source for Repelita V development projects.

**Planning for the RDA.** Concessional loans do not achieve the objective of broader resource mobilization. A lending facility that charges high enough rates to cover its true costs not only maintains its capital base so that it continues to lend but, ultimately, can attract additional funding from private capital markets. To establish proper incentives it is also important for lending rates to be uniform at any point in time. The Plan has called for the development of such a facility (the Regional Development Account, or RDA).

The need for the facility has been much reinforced by the acceptance of Repelita V targets, which call for massive increases in credit financing for the urban sector. The most conservative assumes the channeling Rp. 2.5 trillion in government funds alone in the form of loans.

Principle features of the RDA's present design are: (1) RDA will become the sole central government loan facility, consolidating the various forms of loans previously offered; (2) it will offer loans on uniform terms (including a uniform interest rate at any point in time) for all types of projects through a standard mechanism (thereby eliminating previous inequities across functions and regions); (3) it will lend only for public projects, avoiding public investment where there are few positive externalities and commercial credit is a viable option; (4) it is expected that at the outset, RDA lending will focus on projects that will earn sufficient revenue for the local government or enterprise (either through user charges or increment taxes) to provide strong support for reliable debt service payments (promoting expanded cost recovery throughout the urban development sector is an implicit RDA objective); (5) it will apply standardized and much more rigorous appraisal techniques than have been used in government lending in the past.

Most important, RDA's goal is to establish financial policies to assure its self-sustaining operation as a revolving fund (ultimately essential to broader resource mobilization). It was calculated that, in mid-1990, an interest rate of around 12 percent would be appropriate for this purpose. However, a major World Bank loan package for metropolitan Jakarta (JABOTABEK) was negotiated earlier in 1990 at a nine percent rate, higher than the rates typically applied in municipal lending in the late 1980s, but still below the 12 percent level. It seems unlikely that the RDA will be able to move substantially above this nine percent precedent at the outset, but the design contains language committing RDA to moving to higher levels.

Through mid-1990, substantial implementation planning had been completed for the RDA and had been formally established as an account with Bank Indonesia to be administered by the Ministry of Finance (MOF). Preparations in 1989/90 included the development of a borrower's manual, additional detailing of administrative procedures (Price Waterhouse Siddik, 1990), and additional staff training. A joint BAPPENAS/MOF decree to formally establish the RDA had been drafted and moved to high-level reviews by 8/90. But no agreement had been reached.

### **1990/91 Performance**

Over the past year, agreement on the joint-decree continued to be elusive. Apparently it has been decided that the MOF alone will issue a decree (with the same basic features outlined above) to establish the RDA, but as of 8/91, that decree still has not been signed.

**Domestic Lending Arrangements Under the East-Java Bali Project.** One important step was taken this year, however, to support more disciplined local government borrowing. In its agreement for the World Bank East Java-Bali project, the GOI has agreed to pass on a significant amount of the funds (\$49.5 million out of the \$184.5 million in donor funds) to local governments and their water enterprises in the form of loans, and to use a mechanism that will progressively increase interest rates over time to move toward market rates. Further, the GOI has agreed to apply the same approach in future urban sector loans (World Bank, 1991a).

The Domesticating Lending Agreements (between the GOI and local entities) will be prefinanced from domestic funds with reimbursement to the GOI from proceeds of the World Bank Loan. The six-month average of the three-month Sertifikat Bank Indonesia (SBI) rate at the time of any appraisal will be used as a proxy for the market rate. In setting the rate for any loan, the GOI will apply a pre-agreed discount percentage to this SBI index, but the size of the "discount will be reduced over time and move the onlending rates to market rates in progressive steps." In recent years the donor community has come to understand that where the financial sector has been severely repressed, immediate jumps to market rate are seldom feasible and a more gradual approach makes sense (Peterson, 1990).

Another important precedent in this project is an effective loan-grant linking mechanism. Large and small (rich and poor) urban areas whose PJMs are financed at the same time will have to pay the same interest rate on the loan portion of the funds they receive. But, based on objective assessments of their debt payment capacities, poorer cities will receive a much larger share of total program financing in the form of a grant, whereas richer cities will receive more as loans. Thus, even though the interest rate may be the same, poorer cities will have to pay interest on a much smaller share of their total financing. The total cost to them will be substantially lower than for the more developed areas. Without a mechanism like this, it would be politically difficult to charge progressively increasing interest rates to all local governments, even though doing so will be essential to protecting the integrity of the fund and, thereby, accelerating resource mobilization over the longer term.

### **Priorities for Improvement**

**The RDA and the Loan-Grant Linking Mechanism.** Obviously, the signing of the decree and the formal establishment of RDA should be one of the overall program's highest priorities in the coming year. Steps toward full implementation should then be expedited to get back on track with regard to program resource mobilization objectives. This should include the finalization of: (a) a detailed RDA implementation work program, with clear assignment of responsibilities, activity schedules, and a mechanism for frequent performance monitoring; (b) the development of a longer term strategy for RDA (and sector) resource mobilization; (c) implementing regulations; and (d) the final borrowers manual.

As noted, the policy of using regularly increasing, geographically uniform interest rates is not likely to be upheld politically unless some loan-grant linking mechanism is in place; that is, unless grant allocations can be made in conjunction with loans in a way that more developed local governments are subsidized much less than poorer ones. The approach the Government has taken in the East Java-Bali Project would seem to make a great deal of sense in this context. It both supports the coordinated financing approach of IUNDP and provides a fair method of allocating grants. Efforts should be made to adopt it (or something very much like it) as national policy in conjunction with RDA operations.

**Planning for Longer Term Credit Options for Local Governments.** The RDA, as initially defined, will not be an ideal facility for municipal borrowing over the long term. But implementing it now and experimenting and adjusting as lessons are learned, can be a sound path to better mechanisms that are more independent, and more decentralized, more market oriented.

It would seem important to devote some thinking over the coming year to the possible long-term evolution of opportunities for municipal borrowing that would support expanded resource mobilization. When investment needs are compared with likely public resource availability in the resource mobilization strategy exercise suggested above, the comparison is likely to emphasize the importance of phasing in support from private capital markets. Already, there is interest on the part of subnational governments to access private capital. The province of East Java has, in fact, announced its intention to float a bond issue to finance some development projects, although this may prove to be premature (see Municipal Finance Project, 1991c). However, it would be useful for the Policy Action Plan to call for initial analysis and planning to devise means of adapting the present RDA framework over time, as might be needed to enhance the prospects of private capital market involvement.

It is recognized that this evolution will take some time. Analysis by Donald Gardiner (1990) indicates that even with the recent dramatic reform in the financial sector and the subsequent rapid development of Indonesia's capital markets, conditions are not yet right for a municipal bond system. The number of bond issues of any kind to date has been limited (48 issues totaling Rp. 1.5 trillion since 1983), and there is in effect no market for them. All so far have been "placed" under government direction and held in portfolios until maturity. Potential buyers still see considerable risk in resale potential in relation to other forms of investment. In a Rp. 50 million issue by the BTN (Bank Tambungan Negara) in 1989, Rp. 11 million went unsold and had to be held by the underwriter, at least initially, in its own portfolio. At the same time, the equities market is extremely active and the interests of brokers/underwriters seem to be focused there for the time being. It is also important to remember that no facility now exists to rate the quality of municipal issues--normally essential for an effective market. A more recent review by the Municipal Finance Project (1991c) reached similar conclusions, i.e., that the development of a municipal bond market will take time.

But there are intermediate steps that could be taken. One might be to plan for some decentralizing of RDA operations. As a central government entity, the RDA could quickly become congested if demand expands rapidly. Ultimately there could be great disadvantages in having all appraisal and servicing capabilities housed in its offices in Jakarta. One step could be to decentralize functions to MOF offices in the provinces, but more flexibility might be gained if the RDA had the option of acting as a central rediscounting facility, with other institutions, perhaps the Regional Development Banks, onlending to local governments and enterprises, and thus handling loan origination, appraisal, and servicing functions closer to the locations of the borrowers. Experience with an approach like this should greatly facilitate the eventual involvement of private intermediaries. Not enough is known at present to evaluate such options, but it would seem appropriate to devote some analysis to longer term institutional planning in this way over the coming year.

Another step of importance in this area is the establishment of clear public monitoring of the debt servicing experience of local governments and enterprises on loans from all sources. Regular reports should be prepared on all loans initiated, current balances, the extent of any arrearages, and actions taken to address them. Preparing such reports and publicizing the results can add pressure for good performance and will be necessary at any rate for the ultimate formation of facilities to regularly evaluate the quality of municipal issues in a bond market (see further discussion in Section 5).

## **REFORMING THE ALLOCATION OF CENTRAL GRANTS**

### **Program Development Through 1990**

The program's central objective in grant reform has been to extend more discretion to provincial and local governments over the investment of central budget resources in their areas. This could include giving them more discretion in the use of SDO and Inpres resources and, possibly, reallocating some funds these cities would otherwise receive via DIPS into the Inpres allocations. An additional interest in this area has been to address problems in the criteria by which grants are allocated to different areas. There are reasonable arguments for: (1) using the grant allocation process to redress inequities in economic circumstance (i.e., give more to poorer regions and localities; and, alternatively, (2) use grant making in a manner that provides incentives for greater local resource mobilization, i.e., give more to localities that raise more funds on their own, an approach that could well imply giving less to poorer areas (see discussion of various options in Booth, 1989, and Lamb and Binder, 1987). Awareness has grown that the issues are complex and the design of reforms must obviously be thought through carefully.

Through the mid-1990s, the program had not made much progress in these areas. It is true that to the extent local officials actively participated in the IUIDP process, they had much more influence than ever before over the way central investments (DIPs) would

be made in their areas. But final decisions on those investments still rested with the central departments. A number of proposals for reform of the grants system had been advanced and were actively under discussion, but there was no definitive timetable for resolving issues that remained outstanding.

GOI's budgets did not reflect much change in the position on these issues (see Annex A). From 1985/85 through 1990/91, central grants that are passed on to be spent by local governments (Inpres) averaged 12 percent of total development expenditures and General Inpres grants (as opposed to Sectoral Inpres where tight conditions are placed on permissible expenditures) averaged about half of the Inpres total. There appeared no clear trend either to increase or decrease these proportions during that period.

### **1990/91 Performance**

Over the past year, new legislation to modify the grant system and local taxing authority has been drafted and is apparently very close to the point at which it can be submitted to the legislature. The drafts were not available for review during this mission. However, we were told that they represent more of an incremental change to the present system rather than the wholesale replacement that had been suggested in some earlier proposals. The drafts, however, will further local discretion over the use of grant resources by permitting neither decreases in the share of total grants that pass through the Inpres channel nor decreases in the share of Inpres grants in the General (few strings attached) categories. Reportedly more authority will also be given to local governments in setting rates on local taxes.

One clear accomplishment this year is another precedent the GOI has set in the World Bank East Java-Bali loan agreement (World Bank, 1991a). TKPP data show that out of the total Rp. 2,018.0 billion spent on the urban investment program from 1987/88 through 1989/90, Rp. 427.6 billion was funded by the World Bank's USL and another \$787.3 billion was funded by other donors. Even though the donors uniformly supported the IUIDP approach, the expenditure of 84 percent of the USL funds and 76 percent of the assistance from other donors was allocated through traditional DIP channels, i.e., planned and implemented by central agencies. The innovation in the East Java-Bali approach is the GOI's agreement that a significant share of the funds (56 percent of the \$135 to be allocated through grants) will be channeled directly to be planned and implemented by local governments under the IUIDP process through a special SPABP mechanism under the authority of Inpres.

The GOI has indicated its intention to follow similar arrangements in other donor urban assistance agreements in the future. Also, planning has been initiated for the creation of a new Inpres Perkotaan (a General Inpres in support of the urban investment program), which, like the SPABP mechanism, would give local governments broad discretion in the allocation of funds and direct responsibility for project implementation.

Finally, even though its percentage share did not increase much during the 1980s, it is significant that the GOI has budgeted substantial increases in the absolute amount of total Inpres allocations of late: from Rp. 1.1 trillion in 1988/89 to Rp. 2.3 trillion for 1990/91 and Rp. 3.3 trillion for 1991/92 (World Bank, 1991c). While several of the Inpres channels have too many strings attached, these grants are at least locally administered.

*Section 5*

**INSTITUTIONAL DEVELOPMENT AND  
PROGRAM COORDINATION**

**STRENGTHENING LOCAL GOVERNMENT CAPACITY**

**Program Development Through 1990**

Consistent with Policy 5, the Plan's objectives have included: (1) carrying out a comprehensive study of the urban institutional and manpower development needs of local governments; and then (2) developing a program to strengthen local government capacity based on the results of the study.

**UIMDS.** The study (UIMDS) was completed at the end of 1988 (P.T. Hasfarm Dian Konsultan and DHV Consulting Engineers, 1988). One of its major contributions was a new Human Resource Data Base (HRDB), containing the results of a 30,000 respondent manpower survey. The report's findings and recommendations covered most relevant topics--urban planning, local financial management, urban service delivery, personnel management training, the administrative status of urban areas, internal organizational structures, and training--and examined appropriate roles for central, provincial, and local authorities in each. The report recognized that considerable time will be required to address all of these issues adequately, but it pointed out many other areas in which progress could be made incrementally without waiting for major legal changes. Across all topics, short-term actions could entail organizational tightening to eliminate functional redundancy, by streamlining presently cumbersome procedures and introducing computer-based management systems.

The study's recommendation on training warrant a particularly high priority. Observations during the Second Year Assessment and this one confirm that while training has been provided under several elements of the Policy Action Plan, the results of these efforts are not well documented individually and there has never been a comparative evaluation of their performance. Anecdotal evidence indicates that off-site training (where trainees are sent to a separate facility for lectures and participatory work in subjects relevant to their jobs) have been less beneficial than *on-the-job, learn by doing training experiences*. In the former, there is little guarantee that the trainee will be able to apply what has been learned directly to the job when he or she returns to it. In the latter, the training is designed to fit the job and the new techniques or principles have to be directly applicable to the tasks that are central to the trainees performance. When the trainers depart, the trainees simply continue to do what they have recently gained experience in doing in situ. A comprehensive review with these issues in mind seems very much needed at this point as a basis for future planning.

UIMDS had been much discussed in 1989, and was generally well received. However, through mid-1990, steps had not been taken to form a definite plan of action to deal with its recommendations.

**Systems Support.** The HGL Second Year Assessment noted concern about the development of information systems to support the overall program. Today, probably no device is more important to enhancing local government capacity than a computer-based financial management and accountancy system (covering all sources of revenue and capital as well as routine expenditures). Such systems can form the core for broader planning and control of all municipal activities, in addition to providing the base for financial planning, accounting, and auditing per se. In the overall program, several systems that appeared to be at least partly overlapping in these areas were in process (MAPATDA, PAFPACK, systems developed to support PJM and RIAP formation in IUIDP, and a package developed by Redecon for the Ministry of Finance). The Assessment suggested a comprehensive comparative review of these systems and the development of proposals on how to incorporate the best features of each into a series of useable packages.

**Longer Term Issues.** The HGL Second Year Assessment also noted two longer term concerns in this area. First, was more rapid action on granting appropriate administrative status to urban areas. Unless a city has been given Kotamadya status, there is no public entity that can adequately represent it. It has no government primarily concerned with its own interests as distinct from those of its rural hinterland. In deciding whether or not to borrow from the RDA, for example, the incentives of a Bupati who happens to have a sizeable city within his Kabupaten boundaries are very different than they would be for the Walikota of the city itself. NUDS (1985) proposed a schedule for accelerating the classification of urban areas in Indonesia, but that schedule has fallen far behind. Secondly, UIMDS recognized that present civil service regulations provide strong incentives for would-be public servants to seek employment at the central

rather than the local level and disincentives for talented young managers to seek careers in the public service in general (King, 1988). Ultimately those biases must be eliminated if the program is to succeed.

### **1990/91 Performance and Priorities for Improvement**

The major disappointment over the past year is that a forceful and coherent program still has not been developed to follow up on the UIMDS study. A plan did exist for this to occur under a World Bank-sponsored Local Government Institutional and Manpower Development Project, however, the GOI and the World Bank still have been unable to agree on the structure of this project. The development of some comprehensive program to address these issues, specifically related to urban governments, should be among the program's highest priorities over the coming year.

Progress was made this year toward the rationalization of systems support for the overall program. The Municipal Finance Project called for the preparation of a series of papers describing the various systems that were anticipated or underway and an interagency seminar was held to review them in 12/90. The seminar (see Municipal Finance Project, 1990) assessed the strengths and weaknesses of each system, identified areas of overlap, and developed principles for a more focused and coordinated approach.

The GOI has also made progress on the two new issues noted in the Second Year Assessment. First, the MHA has begun to upgrade the status of local governments. One Kota Administratif (Bitung) has been reclassified as a Kotamadya, and seven more such reclassifications are planned (TKPP, 1991).

Second, a major reform of the civil service system is now underway (World Bank, 1991c). This reform was motivated by the GOI's general recognition of the need to transform public functions to an emphasis on guiding and facilitating private sector development in the economic sphere, rather than on improving local government management per se, but it should be fully consistent with the goals of the overall TKPP program. The process (under the Ministry for the Utilization of the State Apparatus--MEMPAN) is beginning with a broad "job analysis" initiative intended to streamline organizational structures and improve management and technical skills.

In the past, government employees holding "structural" positions, mainly with administrative duties, have benefitted most from the present complex supplementary payments systems in the compensation package. The intent is to use job analysis to create a new system of "functional" positions and career paths that would have clearly defined compensation schedules tied to performance, and to rely more on competitive procedures for promotions (in contrast to the semi-automatic promotion process that currently exists at present). The current system offers substantially greater promotion opportunities to central agency employees than to staff at the Tk. I and II levels. The new system, with numerical credits given uniformly under the functional paths based on work

contribution and professionalism, will eliminate that bias. It would seem important for the next update of the Policy Action Plan to relate more explicitly to MEMPAN in expediting the implementation of these reforms as they affect Tk. I and II governments.

## **SECTOR COORDINATION**

### **Program Development Through 1990**

The program's last policy (Policy 6) addresses the need to strengthen coordination and consultation in the urban development sector. The most basic step under this policy was the formal establishment of TKPP in 1987 and the subsequent decree extending its responsibility for an indefinite period. The forming and initial performance of TKPP has won worldwide recognition (see, for example, Wegelin, 1990), but there had been some concern during 1990 that it was losing some of its initial forcefulness.

Another event of importance in this area had been the forming of a new national Spatial Planning Committee charged with medium-term national level planning for the urban sector. TKPP was to play an important role in this Committee, but by mid-1990 functional responsibilities had not been clarified and a work program had not been developed.

### **1990/91 Performance and Priorities for Improvement**

**Strengthening TKPP.** Several steps were taken this year to strengthen TKPP institutionally. Most important, TKPP chairmanship was vested clearly with Deputy V (responsible for spatial development) in the National Planning Agency (BAPPENAS)--the most logical place for it. Second, the IUIDP Management Group (IMG), established last year to support TKPP, was strengthened through clarification of responsibilities and the establishment of regular meeting schedules (this group is made up of representatives at the Director level and handles day-to-day coordination of the investment program in response to guidance from TKPP, which operates at the Director General level). Finally, after some delay in 1989/90, technical assistance teams funded under the UNCHS-administered IUIDP Implementation Support Project and USAID's Municipal Finance Project (MFP) were mobilized last September. Discussions of their activities throughout this report indicate that they have made important contributions to the work of both TKPP and IMG. So far, they have been working in ways that are compatible. However, it makes sense to coordinate their efforts even more closely to heighten impact.

**The Policy Action Plan.** In 2/91, the TKPP Chairman submitted to USAID an overall examination of the program, reviewing performance under the Policy Action Plan and highlighting issues to be addressed (TKPP, 1991). This submission dealt with the status of work elements under the last (5/90) update of the Plan and presented ideas concerning future priorities. Proposals for the future cover: updating the national urban

strategy, implementing the RDA and taking other steps to strengthen local government finance, continuing the IUIDP and further integrating it into regular government operations, expediting work on local government institutional development and training, strengthening and coordinating information systems at all levels, and providing new emphasis within the program on infrastructure operations and maintenance, urban land management, and urban environmental quality management. These proposals are fully endorsed by the suggestions made in this assessment, and the document forms a useful basis for the next comprehensive Plan update. However, there is an urgent need at this point to translate its general statements into concrete targets with schedule dates, and to do so with the full participation of all relevant agencies in TKPP.

**Systematic Monitoring of Program Performance.** The HGL Second Year Assessment found the need for improvements in systems to monitor the progress of the overall program. There had been reports on individual elements, some of which were excellent, but as of mid-1990 there was no recurrent, comprehensive, factually based reporting on the progress of the program as a whole. It was argued that an elaborate new monitoring system was not required--the need was for a simple quarterly report that would be easy for top decision makers to understand.

Important contributions have been made to this objective during 1990/91. First, the Municipal Finance Project (1991b) has developed a set of statistical indicators on many of the key variables needed to track changes in the intergovernmental finance system, directly related to Policy Action Plan targets. All are presented in chart form, making it possible to see immediately whether conditions are improving or not. Second, Directorate Bina Program has done much to improve its reporting systems on IUIDP progress, which now contain clear tables showing changes in status for each urban area affected (information on related activities such as MAPATDA and training programs are also included). Information on overall program expenditures and financing has also been much improved (the basis for the analysis in Section 2).

Further improvements in this area are needed, however. Most important, the new information from both sources should be integrated into one report and used recurrently as the basis for discussions of progress in TKPP meetings.

Second, some information required to track progress is still either missing or not being presented effectively. At the TKPP level there appears to be a need to improve reporting on the progress of working groups in developing work plans, draft legislation, and so on. Reporting should include tables indicating the dates on which meetings were held and who attended, and explicit citations of any documents produced (with a one paragraph abstract of their content where possible. Additional factual information would also be helpful for programs now being implemented. Examples include: a table on PBB implementation that would show for each city the total number of parcels, total valued to date, recent and expected future collection rates and Rp. yields; some indicators of the extent of involvement of local government officials in PJM/RIAP preparation and

implementation; more data on the characteristics of PJMs by city--e.g., total and per capita investment levels by subsector, data on program composition, and some simple performance ratios; and regularly updated tables showing the number of employees who have received training under each component program in each city.

It may be worth mentioning again one caution given in the Second Year Assessment. There is little doubt that the managers of different program elements would be more strongly motivated if the targets set for them were stated in a clearer and more definite manner than they are in the present Plan. Setting concrete targets, however, is difficult. It is often hard to know what it is feasible to expect ahead of time. The best approach may be to first gain experience by recurrently monitoring more definite measures of performance as suggested above, and then set clearer targets in different areas incrementally as TKPP becomes more confident about defining reasonable expectations in each area.

**Urban and Spatial Strategy.** The TKPP Chairman's 2/91 submission appropriately recommends steps to update the national urban and regional development strategy, working in cooperation with the national Spatial Planning Committee. It seems worth raising again another caution raised in the HGL Second Year Assessment related to effects of spatial strategies on IUIDP. To avoid an overly ambitious charter at the start, IUIDP was purposefully limited to a basic set of functions (water supply, drainage, sanitation, urban roads, and a few other related activities). This is an important set--including all that together really set the spatial pattern *within an urban area*--but there are other functions that have to be considered in local capital budgeting. The PJM/RIAP process has proved to be a basically sound approach for planning local investments and there is little doubt that local officials should expand its scope to cover, for example, budgeting for school and health center development. But what about building new electric power plants, telecommunication facilities, and major roads, that is, *strategic infrastructure*? These are investments in which the provincial and central governments retain a stronger interest since they play a more powerful role in setting the *interurban* pattern of opportunities for economic expansion.

There seems to be general agreement at this point that IUIDP should be broadened and linked to the work of the recently appointed committee for Spatial Planning. However, there is a need for very careful analysis as to how this should be accomplished--analysis that covers the practical administrative implications as well as the economic development aspects. Perhaps there should be two linked but relatively independent processes: one that covers matters fully under the discretion of the localities and another that involves more negotiation between local and higher level governments concerning strategic infrastructure. A concept paper addressing these issues should be developed and discussed over the coming year before definite decisions are made to change IUIDP.

**Central Information System Development and Priority for Analysis of 1980-90 Census Data on Urban Growth.** The TKPP Chairman's 2/91 submission offers sound suggestions about the development of adequate information systems support at the central level for monitoring and coordinating urban development. It stresses the prioritization of activities and coordination to avoid overlaps. Efforts to plan integrated central systems have often failed by setting overly ambitious, all-embracing objectives. Incremental approaches (allowing different users to build components for their own use but retaining the capacity to interface them) have a much better track record. One task that is already clearly specified warrants the highest priority: assembling data from the new decennial census on population and other characteristics that are *exactly* comparable to the definitions used in the NUDS database (i.e., building up desa/kelurahan data to define functional urban areas). Information on 1980-90 population trends in urban areas is now urgently needed as a basis for more effective IUIDP programming in individual cities as well as for nationwide analysis to backup strategy formulation.

## Section 6

### **FUTURE PROGRAM DEVELOPMENT AND THE POTENTIAL FOR AID SUPPORT**

#### **IMPLICATIONS OF ACCELERATED URBANIZATION**

From 1970 to 1980, Indonesia's urban population grew by 1.1 million persons per year. The National Urban Development Strategy project (NUDS, 1985) estimated that between 1980 and 2000, the nation's cities and towns would have to absorb almost twice that rate: 2.1 million persons per year. Preliminary 1990 Census results show that even those estimates understated the magnitude of the challenge. From 1980 to 1990 the urban population in fact grew from 32.8 million to 55.5 million--an average annual growth of 2.3 million. Indonesia's urban growth rate over the past decade (5.4 percent per annum) is among the most rapid experienced anywhere in the world.

This expansion of urban areas has seemed frightening to some, but it has been associated with the strongest period of economic betterment in the nation's history. Considerable growth in per capita incomes and poverty reduction have occurred as Indonesia has undergone a major transformation in its economy. Few would have predicted the success that has occurred in economic diversification by moving away from the dominant dependence on oil characteristic of the 1970s toward substantial growth (mostly by the private sector) in manufacturing and other activities that have generally been outward looking and labor intensive.

No one seriously expects any reduction in the pace of urban growth in the near term. There has been a broader recognition that the future quality of life in Indonesia will be predominantly determined by what happens in its cities and towns, and this has

heightened the GOI's concern both for the issues explicitly addressed in the existing Policy Action Plan and some new issues as well.

Clearly, as TKPP (1991) points out, rapid urbanization is "placing increasingly severe loads on existing urban infrastructure, the capacity to provide new infrastructure, and the capacity to maintain and operate all urban infrastructure efficiently". Intimately linked with infrastructure development is the evident degradation that is taking place in environmental quality and land use. There is also an awareness that urban conditions cannot be improved unless the population at large has sufficient income to pay for improved services and controls. Thus a new priority is attached to urban economic development--development that emphasizes not just more jobs (many who work remain in poverty) but more higher productivity jobs that yield sufficient wages.

## **THE ROLE OF THE POLICY ACTION PLAN**

### **The Existing Agenda**

While its progress has been uneven at times, there is virtually no disagreement in Indonesia's policy community that the basic themes of the current Policy Action Plan policy remain the most effective in coming to grips with Indonesia's urban challenge. These themes include:

- Locally directed, disciplined, and coordinated multi-sector infrastructure programming;
- Expanded local authority and responsibility for resource mobilization and allocation;
- An expanded private sector role;
- Substantial improvements in local government capacity and incentives for its efficient performance in response to local needs.

Some of the disappointments that have been felt about progress under the Plan may have been due to unrealistically ambitious expectations at the start. Over the past two years, understanding has grown about the difficulty of such major transformations as the Plan implies. Today, there seems to be a more realistic view of the timetable needed to secure the Plan's objectives. What is significant, however, is that these objectives, first articulated in 1985, have remained constant for over six years, and while forward movement has not always been as rapid as hoped for, there has not been any actual backsliding on any of them.

And the GOI's achievements under the Plan (as outlined in this report and elsewhere) continue to be impressive in world terms. There can be little doubt that the program, particularly IUIDP implementation, has fundamentally altered the way that Indonesia approaches the development of its cities and towns.

All of this argues strongly for the GOI's continuing to update and forcefully implement the Policy Action Plan in basically its same structure although adaptation to address new themes will, of course, be required. Hand in hand with this conclusion is that the existing TKPP mechanism should also be retained. It should be self-evident that the program is likely to proceed more effectively under the continued pressure of an interministerially supported and coordinated Policy Action Plan at the central level--one that is regularly monitored and adapted in response to changing trends and the emergence of new opportunities. The greatest threats to continued progress would be to disband TKPP and the Plan or to establish alternative mechanisms that weaken them.

### **Weaving New Themes into the Fabric of the Existing Plan**

Given the above, it also makes sense to attempt to address the new themes noted above--urban land and environmental management, urban economic development, and poverty alleviation--in a manner that is either a part of, or well coordinated with, the existing Plan. Surely, new programs by other agencies can be helpful, but recent international research indicates that the most powerful tools for addressing these issues are already a part of the Plan. Most important, *local governments' success in guiding and controlling urban development in these and other ways, more than anything else, depends on the effectiveness of their capital budgeting processes, and in Indonesia, this now means the PJM/RIAP/LIDAP process under IUIDP.*

**Urban Land Management.** The placement of major roads and other trunk infrastructure appears to be the most effective tool local governments can use to guide the physical shape of urban expansion and thus the structure of urban land use. Many experiences in Indonesia show that where government fails to provide new roads and water supply to open up new land in the most promising areas for development on the urban fringe, land development will occur anyway, but in a much less amenable fashion. Alternatively, where new roads and water supply are provided into new lands, private residential and economic investment will follow them (see Dowall, 1987, 1990; Kingsley, 1991; Wunsch, 1991).

In the past the literature has sometimes given more emphasis to land regulations to prevent inappropriate land development. But recent research has shown that in Indonesia, as well as in many other countries, land development regulations are often economically unrealistic. For instance, they require such high standards that homebuilding becomes unaffordable to the majority of new households, thus retarding orderly land development where they are enforced. Furthermore, the institutional capacity needed to enforce detailed regulations seldom exists because doing so would not be cost-effective (Hoffman et al., 1991). The use of more streamlined and affordable regulations has been suggested: rules that focus on the prevention of truly serious structural and environmental problems, but otherwise leave considerable latitude to households and firms in the land development process (Kingsley, 1991). Sound regulations are essential, but if they are to be designed realistically to fit conditions in a

given city, they can best be developed as a part of an expanded planning exercise to back up IUIDP (i.e., capital budget) preparation.

**Urban Environmental Quality Management.** The most serious urban environmental problems are related to improper land development and use--urban expansion into coastal lands, watersheds, flood prone terrain, and other environmentally sensitive areas--and the lack of adequate infrastructure--clean water, decent sanitation, and drainage. Thus the approach to environmental quality management that has the greatest potential is to integrate it within the process by which real local government decisions concerning land and infrastructure are made, i.e., IUIDP. To be sure, adaptation will be necessary if this is to be done well. For example, there needs to be more concern for environmental quality issues in structure planning, a focused comparative analysis of environment risks, better monitoring of environmental conditions, and regular feedback into the planning and investment programming process. But this can best be accomplished within IUIDP.

**Urban Economic Development.** It is now well recognized that the development of decent living conditions and the alleviation of poverty in any city depends first on the creation of adequate employment opportunities in that city. Simply providing a sufficient quantity of jobs to match the growth of the labor force is not enough, however. Many who are now employed do not earn enough to keep their families out of poverty. Thus what is required is more higher productivity jobs, i.e., jobs that yield higher wages. In addition, after much documentation of the failures of public economic enterprises (see, for example, discussion in World Bank, 1991c), the GOI has adopted the view that such economic advancement is to be sought by creating conditions that enhance the efficiency and competitiveness of *private* enterprise.

Considerable research of late has shown that efforts of cities to compete with each other by attempting to lure private investment with tax breaks and other subsidies have been largely self-defeating. Local leaders can best facilitate the growth of higher productivity employment opportunities by altering local conditions so as to make their cities more cost-competitive places to do business. It has been further documented that the provision of efficient public infrastructure systems and the elimination of arbitrary constraints in the land market are among the most effective ways local governments can reduce the costs of doing business for private firms (see Peterson et al., 1991a and 1991b; and Kahnert, 1987). Thus, if they reaches out to focus more explicitly on land management as well as infrastructure, the local planning and investment programming processes already imbedded in the Policy Action Plan are among the most important means localities have available to spur economic development.

## POTENTIAL ROLE FOR FUTURE USAID ASSISTANCE

### Housing Guaranty Lending

When the Policy Action Plan was first established the World Bank relied on it as the basis for its lending agreements with the GOI. USAID came along later and did the same. The World Bank, however, is no longer referencing its loans to progress on the overall program (although it continues to support its themes in its lending for program elements in various regions). At this point, therefore, USAID's HGL funds are the only external resources explicitly keyed to integrated achievement under this program nationwide.

Analysis by several donors has concluded that, even though Indonesia's domestic resource mobilization efforts are succeeding, a reasonable growth path will require external capital assistance for many years to come, and this is particularly true in the urban sector (for example, see World Bank, 1991c). Accordingly, it would seem reasonable for USAID to provide access to additional HGL resources with basically the same understanding that has been applicable over the past few years, *that disbursements of each tranche be based on the GOI's continued progress in implementing its decentralized urban development Policy Action Plan as a whole.*

Although detailed targets and time schedules have not been specified, the TKPP Chairman's 2/91 review offers a sound basis for an update of the Plan. It reinforces the main themes that have been part of the Plan from the start, and identifies new issues in each area that need to be addressed, consistent with overall objectives.

In devising a new loan, the experience of other donors in the urban sector over the past year should be reviewed--particularly, the implications of the East Java-Bali project. It may be possible to adjust the parameters of HG lending so as to: (1) assure a stronger role for TKPP as a whole in guiding the allocation of HGL funds; and (2) assure a greater role of local officials in the more detailed programming of these funds.

### Policy Emphases and Technical Assistance Support

The impact of USAID support for the Plan as a whole should be heightened if it focuses technical assistance resources on policy areas that are: (1) high priorities as recognized by the GOI; (2) do not overlap technical support from other donors or other sources within the government; and (3) areas in which USAID has prior experience in Indonesia. As focal points, analysis in this assessment endorses two ongoing activities and suggests expanded emphasis on a third:

1. **Strengthening Municipal Finance.** USAID technical assistance will continue under the already contracted Municipal Finance Project through mid-1994. This Project has made several important contributions to the overall program since the

team was mobilized a year ago (as documented elsewhere in this report). Its planned activities are designed to directly support the achievement of objectives under Policies 3 and 4 of the existing Plan and themes for its continuation outlined in the TKPP Chairman's 2/91 submission.

**2. Expanding Private Sector Participation.** The new PURSE project (expected to run through 1996) aims at the expansion of private sector participation in urban services, one of the main objectives under Policy 3 of the existing program. As noted earlier, USAID has already provided the primary donor assistance in mobilizing this element of the program, through consultation on forming the initial TKPP agenda in this area and the completion of the WASH studies and seminars on private investment in water supply. PURSE is a priority initiative of USAID/Indonesia and both its design and size promise major strides in solidifying this theme in GOI policy by assisting in the design of legal/regulatory reforms as well as by modifying the orientation of ongoing programs. Its direct coordination with the overall program should be assured in that its primary government counterpart is to be the Chairman of TKPP.

**3. Land and Environmental Quality Management.** Discussion earlier in this section argues that: (1) given the massive urban growth that is now taking place, much improved land and environmental quality management in the cities will be vital to Indonesia's future welfare; and (2) that programmatic efforts to address land and environmental problems are intimately linked. These issues warrant a high priority under a new HG lending program.

USAID has already supported work in these areas. First, legal/regulatory problems related to land development have been recognized as priorities in joint GOI/USAID discussions related to strengthening commercial law in Indonesia. An important result has been a critical evaluation of the workings of the land market and processes for land titling (Hoffman et al., 1991). Second, USAID is now supporting case studies of environmental problems and policy responses in a number of Indonesian cities (to be completed in 10/91). Also, the current USAID technical assistance project reviewing urban management in selected cities and ways to enhance the participation and control of local officials in IUIDP planning will undoubtedly touch on these issues. The work conducted to date has been done at a fairly general level, examining these problems nationwide. The work associated with a new HGL would focus on the means of coming to grips with these problems at the local level and building these techniques into the decentralized processes now proceeding under the Policy Action Plan.

Other donors are also assisting Indonesia in its quest for stronger environmental management. Notably, the World Bank is contributing analysis to support the development of environmental improvement methods across sectors (more rural than urban) at the national level, and its MEIP (Metropolitan Environmental Improvement Project) is focusing on the special environmental problems of Jakarta. No other donor, however, is developing the comprehensive decentralized urban land and environmental

management perspective suggested here--one that should be much facilitated by growing as an integral part of the overall Policy Action Plan under the guidance of TKPP.

### **Next Steps**

While the GOI's continuing commitment to the overall program is evidenced throughout the findings of this report, USAID may wish to consider two additional steps as a part of its deliberations concerning both the disbursement of the fourth tranche under the current loan and the prospects for a new HGL.

First, the TKPP Chairman's 2/91 submission provides a good basis for a full update of the Policy Action Plan. But a full update is needed within a reasonable period of time to continue the momentum of TKPP management, and it should include appropriately revised descriptions of all milestones for achievement and definite target schedules, and go through the full process of TKPP review and acceptance.

Second, improving the system of credit finance for local governments represents an unusually high priority. It is recognized that the establishment of the RDA is only one step in the process of developing an adequate system but, at this point, it is an important step. The GOI is already on-lending resources to local governments--an appropriately structured RDA could much improve the discipline and viability of such lending. Both the Minister of Finance and the TKPP Chairman (in his 2/91 submission) have promised the signing of a decree establishing the RDA in the short term but, as of the completion of this assessment, the decree has not been formally executed.

*Annex A*

**INDONESIA'S PUBLIC FINANCE  
SYSTEM**

This Annex offers a brief description of the structure of, and recent trends in, Indonesia's present system of public finance to facilitate understanding of the review of work under Policies 3 and 4 of the Policy Action Plan.

**GOI BUDGET TRENDS**

Table A.1 shows the changes that have taken place in the GOI budget over the past decade. The budget total represented 24 percent of GDP as the 1980s began, dropped to about 21 percent during the middle of the decade, and returned to the 24 percent level by 1988/89. Internal shifts, however, were much more dramatic.

The corporate tax on oil accounted for 60 percent of total revenues in 1980/81 but then plummeted, reaching 25 percent 10 years later. External assistance (development funds) played the most important role in filling the gap so that variations in the total were less severe. However, the domestic tax effort also much improved, particularly with respect to income taxes, consumption taxes, and the property tax (Pajak Bumi dan Bangunan or PBB).

Routine (recurrent) expenditures accounted for just half of total GOI outlays through the first half of the 1980s, but jumped to and remained at about 62 percent through the last half. This shift was largely accounted for by the increase in debt service payments which jumped from 14 percent of the routine budget in 1980/81 to 49 percent

**Table A.1**  
**GOVERNMENT OF INDONESIA BUDGET, 1980/80 - 1990/91**

	1980/81	1982/83	1984/85	1986/87	1988/89	1990/91
<b>TOTAL EXPENDITURES (Rp. Billions)</b>						
Routine	5800	6996	9430	13559	20739	26648
Development	5916	7360	9952	8332	12251	16225
Total	11716	14356	19382	2189	132990	42873
As percent of GDP	24.0	23.0	21.6	21.3	23.7	NA
<b>PERCENT OF TOTAL</b>						
<b>REVENUES</b>						
Domestic Revenues						
Corp. Tax on Oil	59.9	56.9	53.8	28.9	28.9	25.2
Income Tax	1.4	2.0	2.3	10.4	12.0	15.2
Property Tax	0.7	0.7	0.8	0.9	1.3	1.4
Consump. Tax	6.3	7.9	7.8	23.6	18.8	21.1
Int'l Trade Tax	8.1	5.8	4.4	4.7	4.1	4.9
Other	10.9	13.1	12.9	5.2	4.8	6.0
Subtotal	87.3	86.5	82.1	73.7	69.7	73.7
Development Funds	12.7	13.5	17.9	26.3	30.3	26.3
Total Revenues	100.0	100.0	100.0	100.0	100.0	100.0
<b>EXPENDITURES</b>						
Routine Expend.						
Personnel	34.9	34.6	32.3	31.8	24.1	25.9
Material	11.6	14.9	12.5	10.1	7.2	6.5
Subs. to Regions	16.8	18.8	20.0	19.5	14.6	15.9
Debt Service	13.5	17.5	29.4	37.3	52.8	48.7
Other	23.2	14.3	5.7	1.3	1.3	3.0
Subtotal	100.0	100.0	100.0	100.0	100.0	100.0
Develop. Expend.						
Central						
Departments	42.8	44.3	34.9	24.1	15.2	26.6
Other	19.5	14.8	15.6	12.9	7.8	4.1
Subtotal	62.3	59.1	50.5	36.9	23.0	30.7
Trans. to Reg.						
Inpres	12.1	13.3	13.7	15.5	9.3	14.4
Share Prop. Tax	1.5	1.4	1.6	2.1	2.8	3.1
Subtotal	13.5	14.7	15.3	17.5	12.1	17.5
Project Aid	24.2	26.2	34.3	45.5	64.9	51.8
Total	100.0	100.0	100.0	100.0	100.0	100.0

SOURCE: Compiled from data in World Bank, 1990.

in 1990/91. The routine budget subsidy to the regions is dominantly the Subsidi Daerah Otonom (SDO), which supports operating expenses (mostly personnel costs) of Tingkat (Tk.) I (provincial) governments, and Tk II (Kabupaten and Kotamadya) and lower level governments. The SDO share of routine expenditures increased somewhat through the mid-1980s but then dropped back close to its 1980 level by the end of the decade.

As routine expenditures went up during the decade, the share for development (capital) outlays, by implication, declined. The major change within that category was a substantial drop in the share the central government spent out of its own revenues, largely compensated for by the growth in its expenditure of project aid (external assistance). Project aid increased from 24 percent of all development outlays in 1980/81 to a peak of 65 percent in 1988/89 and then declined to 52 percent in 1990/91.

The remaining categories are transfers to province and local governments for development purposes. Transfers of property tax receipts doubled as a share of the total over the decade, but still represented only three percent of all development outlays in 1990/91. The share for Inpres (Instruksi Presiden) grants varied during the 1980s but showed no clear upward or downward trend.

## **LOCAL GOVERNMENT FINANCES**

Annual tabulations of local finances are not available but data have been compiled for 1986/87 by HIID and the MOF (Quigley, 1990). These data indicate that over 70 percent of all outlays by subnational governments are still funded by grants from the central government. As noted in the Second Year Assessment, this represents one of the highest ratios in the developing world. The remainder is derived from a variety of provincial and local government taxes and service charges and the share of property tax (PBB) revenues passed on to those governments. Local taxes are typically levied, for example, on vehicle registration, vehicle transfer, entertainment, hotel and restaurant receipts, and business registration. Important local user charges are those for water supply, health service, refuse collection, markets, parking, bus stations, taxi stands, and supplying official documents.

The SDO accounted for about two-thirds of subnational government routine revenues (90 percent of their outlays for salaries). PBB transfers made up another 10 percent and local taxes and user charges accounted for the remainder. As to development revenues of these governments, Inpres grants represented 84 percent, the rest coming from PBB transfers and local sources.

## RESTRICTIONS ON THE USE OF CENTRAL TRANSFERS

Most transfers from the central government to the provinces and local governments come with strings attached. These restrictions are discussed in some depth by Lamb and Binder (1987) and Booth (1989). In summary:

**The Property Tax (PBB).** Traditionally, Indonesia's property tax was based on property rent levels, but the base has recently been changed to full market value of land and improvements. The tax rate is set by law (now 0.5 percent of assessments). The assessment ratio (now 20 percent) is determined by the Minister of Finance. Central government offices are responsible for valuation and assessments and collection for certain types of properties (e.g., high value Jakarta properties, plantations). All other collections are handled by local governments. The distribution of receipts is fixed by formula: 9 percent is allocated to cover collection costs, 10 percent is retained by the central government, 16.2 percent is passed on to provincial governments, and the remaining 64.8 percent goes to local governments. These PBB transfers are virtually the only ones subnational governments can spend with complete discretion.

**Subsidi Daerah Otonom (SDO).** The bulk of the SDO covers salaries of "approved staff on permanent establishment account" of subnational governments and such funds, once transferred, cannot be used for other purposes. SDO funds for non-personnel costs come through a separate allocation. These restrictions encourage staff expansion regardless of the real mix of needs for personnel and non-personnel expenditures. Substantial variations in per capita SDO allocations between regions have emerged as the system has evolved (Lamb and Binder, 1987).

**Inpres Grants.** There are several different types of Inpres grants. One group, labeled "Sectoral," is transferred under tight restrictions on the type of expenditures permitted and the standards that must be applied in individual investment decisions. The most important are the Inpres Jalan (for roads), Inpres Sekolah Dasar (for schools) and the Inpres Kesehatan (for health centers).

However, there are also restrictions on most grants in the "General" Inpres category. Regulations are such that Inpres transfers to Kabupaten and Kotamadya governments (Inpres Tk. II) are used almost solely for roads and road-related drainage, maintenance and upgrading. Substantial discretion is allowed only in the use of the diarakhan component of Inpres Tk. I and the use of Inpres Desa (for villages).

## CENTRAL AND LOCAL EXPENDITURES FOR URBAN SERVICES

As indicated above, expenditures on urban infrastructure are made by local governments, largely out of funds provided through central government transfers. But it is estimated (Quigley 1990) that these accounted for only 30 percent of total

expenditures on urban infrastructure during the Repelita IV. The remainder was spent directly by the central government (Daftar Isian Proyek, or DIP, expenditures), mostly by the MPW.

Table A.2 looks more closely at development expenditures over the last half of the 1980s. Regional MPW DIPS accounted for 1.5 to 2.0 percent of all development outlays through most of this period, but jumped up dramatically in 1990/91 to 7 percent. This last increase was largely granted for road and irrigation investments. DIPS of the MPW's Directorate General Cipta Karya (responsible for most IUIDP functions) remained in the 0.6 to 1.1 percent range through 1988/89, dropped sharply to 0.3 percent in 1989/90, and then came back up again to about the mid point of the earlier range in 1990/91. No clear trend is evident.

Inpres grants, in total, averaged 12.1 percent over this period, and the General Inpres category accounted on average for half of that total. Here too, the data show no strong trend (up or down) either for total Inpres or its major subcomponents. In sum, the record of the past five years does not indicate any basic change in the structure of these expenditures. Nonetheless, in absolute terms the 1990/91 changes are important, implying an 84 percent increase for Inpres over the level of the preceding year.

**Table A.2**  
**GOI DEVELOPMENT EXPENDITURES AND INCOME, 1985/86 TO 1990/91**

	1985/86	1986/87	1987/88	1988/89	1989/90	1990/91
<b>TOTAL DEVEL. EXPEND.</b> (Rp. Billion)	10873.9	8333.5	9479.8	12256.0	13129.9	16225.0
<b>PERCENT OF TOTAL</b>						
<b>USE OF FUNDS</b>						
<b>INPRES GRANTS</b>						
General						
Inpres Dati I	2.6	3.5	3.1	2.7	2.5	3.0
Inpres Dati II	1.7	2.3	2.8	2.2	2.1	2.4
Inpres Desa	0.9	1.0	1.1	0.9	0.9	1.1
Subtotal	5.3	6.8	6.9	5.8	5.4	6.5
Sectoral						
Inpres Jalan	0.6	0.9	1.7	1.5	2.2	4.2
Inpres SD	4.8	6.0	2.0	1.1	0.8	2.3
Inpres Kesehat	1.0	1.3	0.8	0.8	0.9	1.2
Other Inpres	0.5	0.6	0.3	0.2	0.1	0.2
Subtotal	7.0	8.7	4.8	3.5	4.1	7.8
Total	12.3	15.5	11.7	9.3	9.5	14.4
<b>CENTRAL EXPEND. (DIPS)</b>						
Regional Pub. Works						
Cipta Karya	0.9	0.6	1.1	0.9	0.3	0.8
Other	0.6	0.4	0.8	0.7	1.7	6.2
Subtotal	1.5	1.0	1.9	1.6	2.0	7.0
Other	29.9	22.3	10.8	29.9	60.8	46.3
Total	31.4	23.3	12.7	31.5	62.8	53.3
OTHER	56.3	61.1	75.6	59.2	27.7	32.4
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0
<b>SOURCE OF FUNDS</b>						
GOI SAVINGS	67.1	31.0	35.0	18.5	13.7	30.4
EXT. DEV. ASSIST	32.9	69.0	65.0	81.5	86.3	69.6
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0

SOURCE: HIID/Ministry of Finance Grants Data Base as presented in Bastin, 1990.

*Annex B*

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